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# THE FUTURE OF COMMUNITY BANKING

ANTHONY GAETA, JR.\*

## I. INTRODUCTION

At the 2015 UNC School of Law Center for Banking and Finance Banking Institute (“Institute”), I was asked to share some of my observations and insights as to the future of community banking in North Carolina.<sup>1</sup> Having represented community banks since 1974, primarily in North Carolina as well as other southeastern states, and having participated in the latest boom of de novo community banks in North Carolina that began in the mid-1990s, I based my observations at the Institute on my past experiences and I attempted to look into the future. It is apparent that my conclusion, which I repeat below, caused some amount of disagreement.

In my conclusion, I stated that “so alas, I see the demise and eventual extinguishment of true small town community banks.” I also said that “I hoped I was wrong, as I have been wrong often in the past.”<sup>2</sup>

The purpose of this Article is to give further thought to the conclusions I expressed at the Institute. In summary, the factors I considered were:

1. Since the early 1990s until 2009 there were a total of 77 community banks whose deposits were insured by the FDIC newly chartered in North Carolina by the North Carolina Commissioner of Banks.<sup>3</sup> I am aware of at least one additional community bank charter issued by the Comptroller of the Currency (OCC); namely, Alamance

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1. Anthony Gaeta, Jr., The Center for Banking and Finance Leadership Award Address at the University of North Carolina School of Law Center for Banking and Finance’s Annual Banking Institute (Mar. 26, 2015) (transcript on file with author).

2. *Id.*

3. E-mail from Rowe Campbell, Chief Deputy Commissioner of Banks, N.C. Office of the Commissioner of Banks, to author (Jan. 12, 2016, 10:53 EST) [hereinafter Campbell E-mail] (on file with author).

National Bank, Graham, North Carolina, which subsequently converted from a national charter to a North Carolina charter.<sup>4</sup>

2. The last community bank chartered in North Carolina was Coastal Bank & Trust, Jacksonville, North Carolina. The date of that charter was April 13, 2009.<sup>5</sup>

3. There have been no banks chartered in North Carolina since the Coastal Bank & Trust charter, and I am unaware of any proposals to charter a new bank in the last six to seven years.

4. Since the early 1990s, the number of banks headquartered in North Carolina has fallen from 186 in 1992 to 65 as of September 30, 2015.<sup>6</sup> This drop in the number of banks headquartered in North Carolina is a result of 106 mergers and 7 bank failures.<sup>7</sup>

## II. NORTH CAROLINA COMMUNITY BANK CONSOLIDATION AND THE STARTUP DROUGHT

Accordingly, an obvious observation is that the supply of newly-chartered banks has come to an absolute halt while the number of community banks in existence has dwindled precipitously. It is true that we have had cycles like this in the past and, in time, new banks were formed in communities where a community bank had been taken over in a merger by a larger competitor. Most of the time, those mergers resulted in a premium to the existing community bank shareholders and many communities saw the community bank cycle of formation, growth, sale, and another new bank formed to fill the community bank void. I can

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4. United Financial, Inc., Current Report (Form 8-K), at 2 (Nov. 24, 2004).

5. N.C. COMM'R OF BANKS, *NC State Charter Banks and Trust Companies*, <https://www.nccob.org/Online/btrts/BanksAndTrusts.aspx> (last visited Jan. 5, 2016). Although three other banks have received charters since 2009, they were not startup *de novo* banks. E-mail from Ray Grace, N.C. Commissioner of Banks, to author (Jan. 11, 2016, 14:39 EST) (on file with author).

6. FED. DEPOSIT INS. CORP., *Institution Directory: North Carolina*, <https://www5.fdic.gov/idas/main.asp>.

7. Campbell E-mail, *supra* note 3.

name communities in North Carolina, such as Wilmington, Monroe, Dunn, Asheville, Raleigh, Charlotte and Rocky Mount, as just a few where this occurred.

In the past, numerous consolidators were anxious to bid for the loans and deposits of successful community banks. Banks throughout North Carolina participated in expansion through acquisition of community banks. These banks included Peoples Bank and Planters National Bank in Rocky Mount, Branch Banking and Trust Company (“BB&T”) in Wilson, First Citizens Bank in Raleigh, Southern National Bank in Lumberton, United Carolina Bancshares in Whiteville, Central Carolina Bank in Durham, Triangle Bank in Raleigh, not to mention the healthy appetite of some of the larger banks such as NationsBank (then NCNB and now Bank of America), Wachovia (now Wells Fargo), Northwestern Bank (now Wells Fargo), and First Union National Bank (now Wells Fargo). In short, in the past there were such a large number of “consolidators” that the popular phrase from the movie “Field of Dreams” rang true: “If you build it, they will come.”<sup>8</sup>

Today, however, many of those consolidators either have been consolidated themselves or have become so large, as in the case of Bank of America, Wells Fargo, BB&T and First Citizens, that the acquisition of a smaller community bank is either not worth the time and expense to consummate such a small transaction or the community bank is in a locale already served by the expanded banking footprint of the potential consolidator. Consequently, we now have less of a competitive environment to acquire community banks. Lesser demand is accompanied by a lower value attached to those banks. This is simple investment banking economics. There are simply not as many buyers in the marketplace. With fewer buyers, the certainty of the end game or “liquidity event” at a handsome or even a reasonable profit, which was always anticipated by investors in a startup community bank, is lessened. Consequently, community bank startup organizers are finding it much more difficult to attract the local investors needed to support a de novo bank than they had in the past. In short, the lack of willing buyers at a premium price means a community bank is just not an attractive investment, limiting the investment capital available for a de novo community bank.

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8. FIELD OF DREAMS (Universal Pictures 1989).

### III. COMMUNITY BANK PROFITABILITY: COMPLIANCE COSTS AND MARGIN COMPRESSION

This lack of investment interest is also negatively impacted by the regulatory burden imposed on all banks in the wake of the financial crisis that commenced in 2008.<sup>9</sup> While it is true that many of the Dodd-Frank regulatory restrictions only impact banks with more than \$10 billion in assets, these regulations have trickled down to the smaller community banks as “best practices.” The result is material expense items not seen before the 2008 financial crisis. Outsourcing much of this regulatory burden is expensive and self-staffing by the community banks is even more impractical from an expense standpoint. Add to this the heightened scrutiny banks face from the federal banking regulators and the increase in consumer protection regulation mandated by the Consumer Financial Protection Bureau and many community bankers I have spoken to feel that they are being hit by a tsunami of over-reaction and over-protection.

Community bankers, in the wake of the financial crisis that I daresay they had very little to do with, are pleading with their Congressional delegations for some regulatory relief to ease the financial burdens and cost of compliance being placed upon them.<sup>10</sup> But the reality is that coming up with an alternative to a “one size fits all” regulatory oversight structure that protects the banking public no matter the size of bank they choose to bank with is proving to be a difficult task.

Adding to this expense burden is the lessened profitability of many community banks due to the historically low interest rate environment.<sup>11</sup> Community banks largely make their profit on the spread between interest charged on loans and interest paid on deposits. Very few have been successful in developing sources of income from non-

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9. See Jeff Bater, *Dallas Fed Report Warns of Compliance Costs on Community Banks*, [2016] Banking Daily (BNA) No. 2 (Jan. 5, 2016) (citing a report by the Federal Reserve Bank of Dallas warning that “more banks may become too small to succeed” due to the increased regulatory burden stemming from the Dodd-Frank Act).

10. See, e.g., Letter from the Am. Bankers Assoc., the Credit Union Nat’l Assoc., the Indep. Cmty. Bankers Assoc., and the Nat’l Assoc. of Fed. Credit Unions to Richard Shelby, Chairman, S. Comm. on Banking, Hous. & Urban Dev., Sherrod Brown, Ranking Member, S. Comm. on Banking, Hous. & Urban Dev., and Members of the S. Banking Comm. (May 15, 2015), <http://www.icba.org/files/ICBASites/PDFs/ltr051515.pdf>.

11. See generally Janet Yellen, Chair, Bd. of Governors of the Fed. Reserve Sys., Opening Statement at Fed. Open Mkt. Comm. Press Conference (Dec. 16, 2015) (transcript available at <http://www.federalreserve.gov/mediacenter/files/FOMCpresconf20151216.pdf>).

interest activities. Margin compression is faced by all community banks; lack of loan demand for many banks aggravates the issue. Simply stated, community banks are not as profitable today as many were in the past. Until interest rates return to more normal levels and until economic growth returns with qualified borrowers in need of loans to support their growth and expansion, community banks will continue to be challenged.

With net income flagging, premiums paid on the sale of the bank will be adversely impacted as will stock price if the bank is publicly traded. Lagging stock prices make investors impatient, and impatient investors put pressure on boards of directors to consider “alternative strategic options”—code for “consider selling the bank!” All of this comes down, in my mind, to make attracting investors a significant challenge for any de novo bank.

#### IV. LOCAL INVESTMENT: ECONOMIC AND REGULATORY HEADWINDS

I have often stated that the startup of a de novo bank is like constructing a three-legged stool. The first leg of the stool requires competent executive management. In the current environment, I see sufficient strength in this category to support the formation of a de novo community bank. The second leg of the stool is a viable economic community where local investors will show their support by investing in and doing business with the de novo bank. My opinion is that there are fewer of those communities in existence now than prior to the crisis, which has taken its toll so that the local economy in many communities is simply not strong enough to support a de novo community bank. The third leg of the stool is the interest of community members in investing in and supporting a startup community bank. In my opinion, this leg is the weakest of the three. The vast majority of investment in the community banks that required recapitalization since the financial crisis has come from private equity funds, not from local communities. The lone exception is the First Carolina State Bank, Rocky Mount, North Carolina, where a recapitalization took place with all investment coming from the local community.<sup>12</sup> I know of no other successful community-based bank recapitalization in North Carolina.

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12. Lee Weisbecker, *BioSignia Exec Raises \$13M to Help Fund Bank Acquisition*, TRIANGLE BUS. J.: TRIANGLE BIZBLOG (Aug. 14, 2012), <http://www.bizjournals.com/triangle/blog/2012/08/biosignia-exec-raises-13m-to-help.html>.

While private equity is available to invest, private equity is not the way to start a bank. Banking regulators want to see broad-based community support, assuming that investors will bring some, if not all, of their banking business to their new community bank. Quite often, a heightened community pride arises and local business and civic leaders provide business and investment to make the new bank a reality. Private equity can only supply capital and not deposit or loan business. Further, because of the financial crisis, regulators will require far more start-up capital for a *de novo* bank than they required prior to the economic downturn. In a larger city, often the capital required for a new bank pre-recession was in the \$15 million range. Today, I have been told by reliable sources at the bank regulatory level that such a minimum would now be closer to \$25 million. Clearly, raising that much additional capital is a hurdle organizing groups who may currently be thinking of starting a bank must consider.

#### V. CONCLUSION

This leads me to the conclusion that, for the foreseeable future, and until the economy returns with robust growth, we will not see any *de novo* banks, we will continue to see consolidation of those community banks started since the 1990s, and the interest in investing in community banks will continue to wane, making the growth of community banks difficult indeed. Without capital accumulation, be it through enhanced profitability or capital investment by willing investors, community banks will find it hard to thrive and possibly even survive; their only recourse may be to sell to a larger competitor at a reasonable price for their investors. My prediction is that many communities that once welcomed and supported community banks will continue to decline and the true community bank serving local community businesses and local citizens will slowly become a relic of the past.

I hope I am wrong . . . I have often been in the past!